Office of Chief Counsel
Internal Revenue Service
memorandum
CC:LM:CTM:SD:POSTF-108977-02
GLGidlund

date: SEP 1 7 2002

to: Victoria Rex, Revenue Agent, Team 1236
450 Golden Gate Avenue
San Francisco, CA 94102

from: Associate Area Counsel (Communications, Technology, and Media: San Diego)

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subject: **Request for Assistance**
Taxpayer: [redacted]
EIN: [redacted]

This memorandum supplements our memorandum dated August 13, 2002. This memorandum should not be cited as precedent.

In our previous memorandum, in discussing issue no. 1, we had concluded that the technical requirements of section 351 had not been met with regard to the transfer occurring on [redacted] because [redacted] L.P. ("[redacted]"), the pre-existing shareholder of [redacted] (the "Taxpayer"), had failed to receive stock in the transfer. On post-review of our memorandum, the National Office has recommended that the Service not pursue this argument in this case.

Instead, the National Office has recommended that the following technical argument be made: Under Treasury Regulation section 1.351-1(a)(1)(ii), where the property contributed in a purported section 351 transfer is of relatively small value compared to the value of stock or securities already owned by the transferor and where the primary purpose of the transfer is to qualify under section 351, such a transfer will fail to qualify for treatment under section 351. In this case, prior to the transfer occurring on [redacted], the Taxpayer, through the sale of [redacted] real property, had realized capital gains in the total amount of $[redacted] for the tax year ended [redacted]. Since you have verified that the [redacted] were sold to unrelated, legitimate parties, these capital gains most likely represent "money" received, as opposed to some form of false bookkeeping entry such as we are accustomed to seeing in these kinds of cases. Further, the Taxpayer's Form 1120, U.S. Corporation Income Tax Return, for the tax year ended [redacted], lists total assets at the beginning of the tax year of $[redacted]. The value of [redacted]'s interest in the Taxpayer should be judged to amount to approximately $[redacted]. (The return also lists certain liabilities, however, based on the usual practices of tax shelter participants, the bona fides of these liabilities are certainly suspect.) The $[redacted] that [redacted] contributed in the purported section 351 transfer should therefore be considered relatively small ([redacted]%) when compared to the total equity interest of approximately $[redacted] of [redacted]. And based on the totality of circumstances surrounding the series of transactions in this case, we conclude that the primary purpose of the contribution of property was to qualify under section 351. As a result, by application of Treasury Regulation section 1.351-1(a)(1)(ii), [redacted] cannot be counted for purposes of the control group, see I.R.C. § 368(a), thus causing the transfer to fail to qualify for treatment under section 351. (Put another way, this argument treats [redacted] as being in the nature of an accommodation party to the transaction.)

The National Office has found acceptable all other arguments expressed in our previous memorandum.

If you have any questions, please call me at (619) 557-6014.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

JAMES W. CLARK
Area Counsel
(Communications, Technology, and Media: Oakland)

By: Gordon L. Gidlund

GORDON L. GIDLUND
Associate Area Counsel
(Communications, Technology, and Media: San Diego)

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subject: **Request for Assistance**
Taxpayer: [redacted]
EIN: [redacted]

This memorandum responds to your request for assistance in this case. This memorandum should not be cited as precedent.

ISSUES:

1. Whether the purported section 351 transfer occurring on [redacted] fails to meet the technical requirements of the statute, so as to justify the adjustment of the loss of $[redacted] claimed upon the subsequent sale of stock received in that transfer?

2. Alternatively, whether the purported section 351 transfer occurring on [redacted] fails to meet the required business purpose test, so as to justify the adjustment of the claimed loss of $[redacted]?

3. Alternatively, whether the basis of the asset transferred in the purported section 351 transfer occurring on [redacted] must be reduced in accordance with section 358(d)(1), thus requiring the adjustment of the claimed loss of $[redacted]?

4. Alternatively, whether the primary purpose for the transferee assuming a liability in the purported section 351 transfer occurring on [redacted] was not a bona fide business purpose, thus requiring the adjustment of the claimed loss of $[redacted]?

5. Alternatively, whether section 482 applies to allow the Service to disallow the claimed loss of $[redacted] and to allocate it back to the transferor in the purported section 351 transfer occurring on [redacted]?

6. Alternatively, whether the adjustment of the claimed loss of $[redacted] is justified as it was derived from transactions that lacked economic substance?

7. Whether the facts of the case justify assertion of the accuracy-related penalty under section 6662(a)?

CONCLUSIONS:

1. The purported section 351 transfer occurring on [redacted] fails to meet the technical requirements of the statute, thus justifying the adjustment of the loss of $[redacted] claimed upon the subsequent sale of stock received in that transfer.

2. Alternatively, the purported section 351 transfer occurring on [redacted] fails to meet the required business purpose test, thus justifying the adjustment of the claimed loss of $[redacted].

3. Alternatively, the basis of the asset transferred in the purported section 351 transfer occurring on [redacted] must be reduced in accordance with section 358(d)(1), thus requiring the adjustment of the claimed loss of $[redacted].

4. Alternatively, the primary purpose for the transferee assuming a liability in the purported section 351 transfer occurring on [redacted] was not a bona fide business purpose, thus requiring the adjustment of the claimed loss of $[redacted].

5. Alternatively, section 482 applies to allow the Service to disallow the claimed loss of $[redacted] and to allocate it back to the transferor in the purported section 351 transfer occurring on [redacted].

6. Alternatively, the adjustment of the claimed loss of $[redacted] is justified as it was derived from transactions that lacked economic substance.

7. The facts of the case justify assertion of the accuracy-related penalty under section 6662(a).

FACTS:

Our advice is contingent on the accuracy of the information that the Internal Revenue Service has supplied. If any information is uncovered that is inconsistent with the facts recited in this memorandum, you should not rely on this memorandum, and you should seek further advice from this office.

[redacted] (the "Taxpayer") was incorporated on [redacted] in the State of California. According to its initial Form 1120, U.S. Corporation Income Tax Return, for the [redacted] tax year ended [redacted], and according to its current law firm, upon incorporation, the Taxpayer had one shareholder: [redacted] ("[redacted]"), TIN: [redacted], a [redacted] entity, the ownership of which is unknown.[1] Also according to its initial Form 1120, the Taxpayer's business activity was real estate, with its product or service being rentals.

The Taxpayer was capitalized through an ostensible section 351 transfer from [redacted] of all that entity's assets, which, according to the Transferee's Statement under Regulation Section 1.351-3(b) attached to the Taxpayer's initial Form 1120, consisted of the following:

Item of Property	Adjusted Tax Basis as of [redacted]
Cash	[redacted]
Buildings & Improvements (Net of Depreciation)	[redacted]
Loan Fees (Net of Amortization)	[redacted]
Lease Commissions (Net of Amortization)	[redacted]
Land	[redacted]
Total	[redacted]

The Buildings & Improvements and Land consisted of [redacted] property, apparently [redacted] on the Form 4797, Sales of Business Property, attached to the Taxpayer's Form 1120 for the tax year ended [redacted]. In exchange for these assets, [redacted] received [redacted] shares of the Taxpayer's stock, which was all its outstanding stock at that time.

Also according to the [redacted] Form 4797, the [redacted] property were sold by the Taxpayer on various dates beginning on [redacted] and ending on [redacted], resulting in a capital gain of $[redacted].[2] This capital gain, however, was entirely offset by a loss claimed on account of a sale, taking place on [redacted], the last day of the Taxpayer's fiscal year, of [redacted] shares of stock in [redacted] ("[redacted]"), a Nevada corporation, which shares had been received in a purported section 351 transfer occurring on [redacted], which transfer will be described below, and which stock had a purported tax basis of $[redacted] and a fair market value of $[redacted].

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[1] In a letter dated [redacted], written in response to summonses issued by you, one of the attorneys for the Taxpayer, [redacted], explained that "to the best of our knowledge," [redacted] was the original shareholder of the Taxpayer. She also wrote: "We have not been able to identify the shareholders of [redacted]." Most likely, the Taxpayer will attribute its lack of knowledge of its own past to the change in ownership that occurred on [redacted], which will be described below.

[2] You have verified that the [redacted] were sold to unrelated, legitimate parties, one, for example, being [redacted].

The tax basis of the [redacted] stock as claimed by the Taxpayer was derived from a series of lease-stripping transactions that began with a purchase agreement dated [redacted] under which [redacted] ("[redacted]"),[3] a Minnesota corporation, sold the retail store fixtures used in its [redacted] to an entity called [redacted] ("[redacted]") in exchange for two promissory notes, the first a recourse note in the amount of $[redacted] payable [redacted] days from [redacted] and the second a nonrecourse note (the "[redacted] Note") in the amount of $[redacted] payable in quarterly installments of $[redacted] commencing on [redacted] and ending on [redacted]. By a "User Lease," also dated [redacted], [redacted] leased the store fixtures back to [redacted] for the exact same term, installment amounts, and payment dates as the [redacted] Note. So with the exception of the $[redacted] short-term note, this transaction represents the kind of typical circular cash flow arrangement that commonly appears in tax shelter situations. *See, e.g., ACM Partnership v. Commissioner*, 157 F.3d 231, 250 (3d Cir. 1998); *Sheldon v. Commissioner*, 94 T.C. 738, 769 (1990).

By another purchase agreement, also dated [redacted], [redacted] sold the store fixtures and the right to rent receivables due from [redacted] under the User Lease to [redacted] ("[redacted]"), a Nevada general partnership, in exchange for two promissory notes, the first a recourse note in the amount of $[redacted] payable in [redacted] days from [redacted] and the second another recourse note in the amount of $[redacted] also payable in [redacted] days from [redacted] and for the assumption by [redacted] of [redacted]'s obligation under the [redacted] Note. With the exception of the $[redacted] short-term note, this transaction presents another example of a circular cash flow arrangement.

By yet another purchase agreement, dated [redacted], [redacted] sold the store fixtures and the right to rent receivables due from [redacted] under the User Lease to an entity called [redacted] ("[redacted]") in exchange for two promissory notes, the first a recourse note in the amount of $[redacted] payable in [redacted] days from [redacted] and the second a nonrecourse note ("[redacted] Note") in the amount of $[redacted] payable in [redacted] semiannual installments commencing on [redacted] and ending on [redacted], with all but two installments in the amount of $[redacted], and those two being the first installment due on [redacted] in the amount of $[redacted] and the last installment due on [redacted] in the amount of $[redacted]. By a "Master Lease," also dated [redacted], [redacted] leased the store fixtures back to [redacted] for the exact same term, installment amounts, and payment dates as the [redacted] Note, again, more or less, presenting a circular cash flow transaction.

[redacted] then sold the right to rent receivables due from [redacted] under the User Lease to [redacted] under a Rent Sale Agreement, dated [redacted]

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3 [redacted] and manages [redacted], [redacted], and the [redacted], [redacted], and [redacted] department stores.

At some point after this rent sale and before or on [redacted], [redacted] sold the store fixtures and its right to rent receivables due from [redacted] under the Master Lease to [redacted] ("[redacted]"), a Delaware corporation, in exchange for [redacted] assuming [redacted]'s offsetting obligation to make payments under the [redacted] Note. On [redacted], [redacted] sold the store fixtures to [redacted] ("[redacted]"), a Nevada general partnership, for a total purchase price of $[redacted], consisting of a cash payment of $[redacted] and the assumption of [redacted]'s unpaid obligation under the [redacted] Note. In exchange, [redacted] received the right to rent receivables due from [redacted] under the Master Lease. By means of this transaction (not counting the cash payment of $[redacted]), [redacted] simply stepped into the shoes of [redacted] by assuming its position in this circular cash flow transaction. Since the term of the Master Lease was to end on [redacted], and so allowing for a two-year "window" following the expiration of the User Lease, the cash payment of $[redacted] by [redacted] was presumably a payment for this residual value.

Also on [redacted], [redacted] sold the store fixtures to [redacted] ("[redacted]"), a Delaware corporation, which included the right to rent receivables due from [redacted] under the Master Lease. The total purchase price of the store fixtures was $[redacted], payable through a short-term promissory note in the original principal amount of $[redacted], with [redacted]% interest, due on [redacted], and through an installment note ("[redacted] Note") in the principal amount of $[redacted], with [redacted]% interest, payable in [redacted] installments of $[redacted] and due on the last day of each month from [redacted] through [redacted].[4] On that same day, [redacted], by an Agreement of Lease (the "Over Lease"), [redacted] leased the store fixtures back to [redacted], which included the right to rent receivables due from [redacted] under the Master Lease, with rent payable by [redacted] for the exact same term, installments amounts, and payments dates as the [redacted] Note. As a result of this sale-leaseback arrangement, for the effective price of $[redacted] with an [redacted]% interest payment due in [redacted] months' time, [redacted] obtained title to the store fixtures, although subject to numerous encumbrances, and thereby obtained the benefit of depreciation and other deductions related to the store fixtures.

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[4] The amounts listed with regard to the purchase of the store fixtures are derived from copies of the Purchase Agreement entered into between [redacted] and [redacted], the short-term promissory note, and the [redacted] Note that were provided by the Taxpayer in response to your summons. Interestingly, Lead Counsel to the Technical Advisor, Leasing Promotions, who has thoroughly researched the underlying lease-stripping transactions, has provided us with copies of a set of documents identical to those obtained pursuant to the summons but for the alteration of certain amounts. For example, according to this other set of documents, the total purchase price of the store fixtures was $[redacted], the amount of the short-term promissory note was $[redacted], and the interest rate for the [redacted] Note was [redacted]%. The action of the parties to these transactions in providing inconsistent yet purportedly binding documents to different offices of the Service certainly casts doubt on the bona fides of these various transactions.

On [redacted], [redacted] sold the right to rent receivables due from [redacted] under the Master Lease to [redacted] ("[redacted]"), a Delaware corporation. As payment, [redacted] assumed [redacted]'s obligation under the [redacted] Note that it had assumed from [redacted] in connection with its purchase of the store fixtures from [redacted].

On [redacted], as part of a purported section 351 transfer, [redacted] transferred a [redacted]% undivided interest in the [redacted] Note and a [redacted]% undivided interest in [redacted]'s rights and obligations[5] under the Over Lease to a subsidiary of [redacted] ("[redacted]"), a Delaware corporation, which was merged into [redacted] less than a month later, on [redacted]. In exchange for those [redacted]% interests, [redacted] transferred to [redacted] shares of its stock, which presumably converted to stock in [redacted] upon the merger. According to the Transferee Statement Under Treasury Reg. 1.351-3(B) attached to [redacted]'s Form 1120 for the tax year ended [redacted], the [redacted]% undivided interest in the [redacted] Note constituted a receivable that was payable in monthly installments of $[redacted], with a purported tax basis of $[redacted] and a fair market value of $[redacted].

On [redacted], in another purported section 351 transfer, [redacted] transferred the [redacted] shares of the then-designated-[redacted] stock to the Taxpayer in exchange for [redacted] shares of the Taxpayer's stock. The Transferee Statement Under Treasury Regulation 1.351-3(B) attached to the Taxpayer's [redacted] Form 1120 lists the [redacted] shares as having a purported tax basis of $[redacted] and a fair market value of $[redacted]. And according to that Transferee Statement, the other party to the purported section 351 transfer was [redacted] L.P. ("[redacted]"), a Delaware limited partnership, which had purchased all the outstanding [redacted] shares of the Taxpayer's stock from [redacted] [redacted] days earlier, on [redacted]. The Transferee Statement described [redacted] as transferring cash of $[redacted][6] to the Taxpayer

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[5] [redacted]'s "rights" under the Over Lease would be the rights to the store fixtures during any window period between the expiration date of the Master Lease, [redacted], and the expiration date of the Over Lease, [redacted] The "obligations" would consist of the requirement to make rental payments to [redacted] but as noted above, the amount of those payments exactly equaled the amount of the note payments (with the two sets of payments even falling due on the same days), leaving that relationship simply a circular cash exchange, that is, assuming cash even was exchanged, as opposed to the common corporate tax shelter practice of simply maintaining offsetting bookkeeping entries. (Incidentally, the fact of [redacted] assuming the rights and obligations under the Over Lease is only found in [redacted]s. [redacted], letter.)

[6] According to the [redacted], letter of [redacted], [redacted] transferred $[redacted] "[redacted]" to the Taxpayer. A document entitled "[redacted]," and (continued...)

but receiving no stock in exchange, leaving the relative ownership interests of the Taxpayer at [redacted] shares for [redacted] and at [redacted] shares for [redacted]

On [redacted], the Taxpayer sold the [redacted] shares of [redacted] stock to [redacted], a recurring tax-shelter accommodation party, for $[redacted] As the Taxpayer claimed a tax basis of $[redacted] in the stock, the Taxpayer thereafter claimed a loss of $[redacted] resulting from this sale, which loss completely offset the capital gain of $[redacted] resulting from the sale of the [redacted] real property. You request our assistance with regard to possible disallowance of or other adjustment to the claimed capital loss. Finally, it should be noted that the Taxpayer has been essentially inactive since the tax year ended [redacted] (The Taxpayer's Forms 1120 for the tax years ended [redacted] and [redacted] list interest income of only $[redacted] and $[redacted], respectively, and its Form 1120 for the tax year ended [redacted] lists no income.)

On October 15, 2001, you served summonses on the collective representative of the Taxpayer, of [redacted], of [redacted] and of [redacted] seeking documents relating to the various transactions and explanations for such matters as business purpose and valuation. Certain documents and explanations were provided under a cover letter dated [redacted], but many documents were not provided and many questions were not answered. By a Form 4564, Information Document Request, dated [redacted] you sought responses to unanswered requests and questions from the summonses, as well as clarifications to those responses previously provided. By a cover letter dated [redacted], the collective representative for the Taxpayer and the other summonsed parties provided one document but otherwise indicated that no further responses would be forthcoming and requested the issuance of a 30-day letter.

LAW AND ANALYSIS

1. Whether the purported section 351 transfer occurring on [redacted] fails to meet the technical requirements of the statute, so as to justify the adjustment of the loss of $[redacted] claimed upon the subsequent sale of stock received in that transfer?

Nonrecognition treatment is accorded to transfers of property "by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation"

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[6](...continued) dated [redacted], indicates that the amount transferred by [redacted] was "$[redacted]," and further, this document indicates that this "[redacted]" was "[redacted]" of the Taxpayer. We have been unable to reconcile the two stated amounts purportedly transferred to the Taxpayer.

to which the property is transferred. I.R.C. § 351(a). For purposes of section 351, control is defined as ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the transferee corporation (the "control requirement"). I.R.C. § 368(c). As expressly indicated in the above-quoted language of section 351(a), more than one transferor may be involved, so long as those transferors as a group meet the control requirement. Each transferor, though, as that term is understood in the context of section 351, must not only transfer property but must also receive stock in exchange.[7]

Both the Transferee Statement Under Treasury Regulation 1.351-3(B) attached to the Taxpayer's [redacted] Form 1120 and [redacted], letter indicate that [redacted] received no stock in return for the $[redacted] transferred to the Taxpayer.[8] As a result, the transaction fails the control requirement of section 351(a). The failure of [redacted] to receive stock of the Taxpayer in exchange for the $[redacted] means that [redacted] is not a qualifying transferor under section 351, and since [redacted], as the post-transfer owner of [redacted]% of the Taxpayer's stock is not a qualifying transferor, the transaction fails to meet the control requirement.

As a result of the failure of the [redacted], transaction to meet the technical requirements of section 351, we must separately analyze the [redacted] transfers to the Taxpayer. Based on our facts, the transfer of $[redacted] by [redacted] to the Taxpayer constitutes simply a contribution to capital as that term is understood in the context of section 118(a). The transfer of the [redacted] shares of [redacted] stock by [redacted] to the Taxpayer constitutes an exchange governed by section 1032, under which no gain or loss is recognized by a corporation on the receipt of money or other property in exchange for its stock. In determining the basis of the property received, Treasury Regulation section 1.1032-1(d) provides that as to a section 1032 transaction that does not qualify under any other nonrecognition provision, section 1012 applies to set the basis of the property as "the cost of such property." And Treasury Regulation section 1.1012-1(a) defines "cost" to mean the "amount paid" for the property in cash or other property. In this case, the

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[7] The only exception to this rule would be where the transferor is the 100% owner of the transferee corporation both before and after the transfer, so that the issuance of additional stock would be a meaningless gesture. *See* Rev. Rul. 64-155, 1964-1 C.B. 138 (holding the exchange of stock in a section 351 transfer unnecessary where the transferor's receipt of additional stock would not change the level of ownership interest in the wholly owned transferee subsidiary). *See also*, *Lessinger v. Commissioner*, 85 T.C. 824, 836 (1985), *rev'd on other grounds*, 872 F. 2d 519 (2d Cir. 1989) (holding the requirements of section 351 were met in a transfer to a wholly owned subsidiary although no additional stock was issued). Since [redacted] owns stock of the Taxpayer after the transfer, in addition to [redacted], this exception does not apply.

[8] The only contrary indications of a cash-for-stock exchange is contained in the document referred to above in footnote 6.

Taxpayer "paid" [redacted] shares of its own stock for the [redacted] shares of [redacted] stock. We have no information on the value of shares of the Taxpayer's stock *per se*, but the [redacted] shares were sold for $[redacted] less than two months after the purported section 351 transfer and the Taxpayer's own Transferee Statement Under Treasury Regulation 1.351-3(B) lists the [redacted] shares as having a fair market value of $[redacted] as of [redacted], the date of the purported section 351 transfer.[9] Without a more convincing explanation from the Taxpayer than we have received thus far, we must then assign the value of $[redacted] to the [redacted] shares.

2. Alternatively, whether the purported section 351 transfer occurring on [redacted] fails to meet the required business purpose test, so as to justify the adjustment of the claimed loss of $[redacted]?

Section 351 requires a business purpose before granting nonrecognition treatment. *See Stewart v. Commissioner*, 714 F.2d 977, 992 (9th Cir. 1983). Generally, section 351 will apply to a transaction if the taxpayer has any valid business purpose for the transaction other than tax savings. *Id.* at 991; Rev. Rul. 60-331, 1960-2 C.B. 189, 191. The Service and the courts have distilled several factors that aid in determining whether a valid non-tax business purpose is present in a purported section 351 transaction. These factors include: (1) whether the transfer achieved its stated business purpose; (2) whether the transfer primarily benefitted the transferor or the transferee; (3) the amount of potential non-tax benefit to be realized by the parties; (4) whether the transferee corporation is a meaningless shell; (5) whether the transferee's existence is transitory; (6) whether the transferee corporation has any other assets of the type transferred; (7) the number of times the property was transferred, both prior to and after the section 351 transaction; (8) the amount of time each party held the property, both prior to and after the section 351 transaction; (9) whether there were any pre-arranged plans concerning future dispositions of the property; and (10) whether there were independent parties (such as creditors) that requested a specific structure for the transaction.

If we review the factors just listed, factors (1), (3), (4), (5), and (6) are the most relevant to this case. Under factor (1), in her [redacted] letter, [redacted] described the Taxpayer's business purpose in acquiring the [redacted] shares of [redacted] stock as the obtaining of additional capital and the diversification of its investments. The Taxpayer ostensibly did obtain $[redacted] in additional capital, although at the cost of the issuance of stock in an amount purportedly of the same value. As to the diversification of

[9] As noted earlier, even the Transferee Statement Under Treas. Reg. 1.351-3(B) attached to [redacted]'s Form 1120 for the tax year ended [redacted] lists the fair market value of the [redacted]% interest transferred by [redacted] in exchange for the [redacted] shares as $[redacted] as of [redacted], a year and a day before this transfer, suggesting that this stock was considered quite stable in value.

investments, the stock was sold less than [redacted] months later, certainly calling into question the sincerity and commitment of that investment choice.

Under factor (3), the amount of non-tax benefit appears to be only the difference between $[redacted] in cash and the detriment in issuing additional stock, which the Taxpayer may argue is great, making this a good deal for it, but this benefit only derives from an improper application of the tax laws.

Under factors (4) and (5), based on its whole history, the Taxpayer does appear to be a meaningless shell with a transitory existence. Although its creators observed business formalities for perhaps a few more years than the normal shelf-life of a tax-shelter entity, its only apparent purpose was to sell the four parcels of real property owned most likely by foreign investors and then to move the sales proceeds offshore. Once that transaction was completed, the Taxpayer effectively closed down, probably only remaining in existence to serve as a shell corporation when convenience again called.

Under factor (6), besides the [redacted] real property transferred to it upon incorporation and the [redacted] shares of [redacted] stock, the Taxpayer apparently had no other assets.

As a result, we conclude that the [redacted], transfer fails to meet the required business purpose test.

3. Alternatively, whether the basis of the asset transferred in the purported section 351 transfer occurring on [redacted] must be reduced in accordance with section 358(d)(1), thus requiring the adjustment of the claimed loss of $[redacted]?

If the Taxpayer is able to prove that stock was in fact received by [redacted] in the [redacted], transaction, thus meeting a technical requirement of section 351, and the Taxpayer is able to meet the required business purpose test of section 351, we must consider the issue of the purported carryover basis for the asset that is transferred to the Taxpayer on [redacted]. Section 362(a) provides that in a section 351 transfer, in which the transferor receives only transferee stock, the transferee corporation's basis in the property received will be the same as it would be in the hands of the transferor, increased by the amount of gain recognized to the transferor on such transfer. Since the [redacted] shares of [redacted] stock were received by [redacted] in an earlier purported section 351 transfer, that transfer, the one occurring on [redacted], must, in turn, be analyzed to determine [redacted]'s basis in the [redacted] shares.

The bona fides of the [redacted], transaction are certainly in question. [redacted] received stock in [redacted], and [redacted] received [redacted]% of a note receivable but also [redacted]% of a rent payable in effectively the same amount. In her [redacted], letter, [redacted], who represents [redacted] and [redacted], as well as the Taxpayer, described the business purpose of [redacted] in the transaction as diversification of investments and described the business purpose of [redacted] as the obtaining of additional capital. As will be argued below, both these claims are incredible. But even if we assume the propriety of the purported section 351 transfer occurring on [redacted], the basis claimed for the [redacted] shares may still be challenged by application of section 358(a)(1) and (d)(1).

Under section 358(a)(1), the transferor's basis in the stock of the transferee corporation received in a section 351 transfer is equal to the transferor's basis in the property exchanged. But under section 358(a)(1)(A), such basis is reduced by, among other things, the amount of any money received by the transferor. The general rule of section 358(d)(1) provides that where another party to the transfer assumes a liability of the transferor, such assumption shall be treated as money received by the transferor, thus requiring the reduction of the basis of the stock by the amount of the assumed liability.

The Taxpayer may argue that because the liability assumed by the transferee, [redacted], was an obligation to make rental payments to [redacted] under the Over Lease, it was one that gave rise to a deduction, and consequently falls within the scope of section 357(c)(3)(A)(i). Basis reduction, the Taxpayer may argue, is prevented by operation of the exception to the general rule of section 358(d)(1), that is, section 358(d)(2), which incorporates section 357(c)(3) by reference.

But the liability assumed by [redacted] in the purported section 351 transfer occurring on [redacted] was not one as contemplated by section 357(c)(3)(A)(i). As described in facts, even before the transfer of the [redacted]% interest under the Over Lease, the related rental income had been separated ("stripped") from the underlying leased property by the Rent Sale Agreement, dated [redacted], between [redacted] and [redacted]. As explained in Chief Counsel Notice 2001-033a, "Contingent Liability Tax Shelters (Revised)," dated June 28, 2001:

> [S]ection 357(c)(3)(A)(i) refers to a liability that would give rise to a deduction to the transferee, not the transferor. Although authorities such as Rev. Rul. 95-74,1995-2 C.B. 36, permit a corporate transferee to claim deductions accruing upon payment of assumed liabilities, such authorities only apply if there is a transfer of a trade or business and, at the time of the section 351 exchange, the taxpayer had no plan to dispose of the stock received. In Notice 2001-17 transactions, there is no transfer of a trade or business and there is a plan to dispose of the stock immediately after the sale. Therefore, these transactions are not within the scope of Rev. Rul. 95-74. As a result, the taxpayers in these cases are subject to the rule set forth in *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946), that the assumption of the liability is part of the cost of acquiring the transferred asset and so the payment of the liability does not give rise to a deductible expense for the transferee. In such a case, the deduction upon payment by the transferee should accrue to the transferor, in which case there is no need to preserve the loss in the stock

basis. Accordingly, the liability is not within the scope of section 357(c)(3)(A)(i), its assumption is therefore not within the scope of section 358(d)(2), and the general rule of section 358(d)(1) applies to reduce the stock basis by the amount of the liability.

[redacted] transferred no trade or business whatsoever to [redacted] leaving section 357 inapplicable. All that was transferred was a perfectly matched set of offsetting rights and obligations. As a result, section 358(d)(1) must be applied to reduce the basis of the stock. As of [redacted], the principal outstanding amount fo the [redacted] Note was $[redacted]. In her [redacted], letter, [redacted] explains that the basis of the [redacted]% undivided interest in the note was calculated simply by multiplying that then-current amount by [redacted], leaving a result of $[redacted]. Presumably the amount of liability assumed can be calculated with a similar convenience, so that since the original note payments exactly equaled the rental payments under Master Lease, a safe assumption here would allow that the basis of the [redacted]% undivided interest be reduced to [redacted], which would mean the concomitant reduction of the basis of the [redacted] shares.[10]

4. Alternatively, whether the primary purpose for the transferee assuming a liability in the purported section 351 transfer occurring on [redacted] was not a bona fide business purpose, thus requiring the adjustment of the claimed loss of $[redacted]?

Even if section 358(d)(1) were not applicable to reduce the basis of the [redacted]% interest in the [redacted] Note, a comparable result may be reached under section 357(b). Section 357(b)(1)(B) provides that if, taking into consideration the nature of the liability and the circumstances under which the arrangement for the assumption was made, it appears that the taxpayer's principal purpose in assuming the liability was not a bona fide business purpose, then such assumption shall, for purposes of section 351, be considered as money received by the taxpayer on the exchange.

On the above facts, the primary purpose for the assumption of the obligation to make rental payments to [redacted] under the Over Lease was to create an asset (the [redacted] stock) with a basis far in excess of its value, in order to sell that asset and thereby generate a substantial tax loss, with no bona fide economic loss suffered by any party to the transaction. This is not a bona fide business purpose. Thus, even if section 358(d)(1) were treated as not applying to the subject transactions, the assumption of the obligation to make rental payments to [redacted] under the Over Lease is squarely within the scope of section 357(b)(1)(B) and the liability assumption is treated as a distribution of money to [redacted], the transferor, on the exchange. Under section 358(a)(1)(A)(ii), [redacted]s basis in the stock is thus reduced by the value of the leasehold obligations assumed by the corporate transferee, [redacted], later [redacted].

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[10] These transactions occurred before [redacted] and therefore section 358(h) would not be applicable.

5. Alternatively, whether section 482 applies to allow the Service to disallow the claimed loss of $[redacted] and to allocate it back to the transferor in the purported section 351 transfer occurring on [redacted]?

Under section 482, the Service may allocate income or deductions between entities owned or controlled by the same interests in order to prevent the evasion of taxes or clearly to reflect income. The regulations under section 482 define control to include "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-1(i)(4); T.D. 8552, 1994-2 C.B. 93, 105. The regulations also state that it is "the reality of control that is decisive," rather than a rigid focus on record ownership of the entities at issue. *Id.; accord Ach v. Commissioner*, 42 T.C. 114, 125 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966); *Charles Town, Inc. v. Commissioner*, 372 F.2d 415, 419-20 (4th Cir. 1967), *aff'g* T.C. Memo. 1966-15. A presumption of control arises if income or deductions have been arbitrarily shifted as a result of the actions of two or more persons acting in concert with a common goal or purpose. Treas. Reg. § 1.482-1(i)(4).

Once control is established by demonstrating that a common plan existed to arbitrarily shift income and deductions, it must be determined whether the control was exercised by the same interests. Although the phrase "same interests" is not defined in the regulations under section 482, case law as well as the legislative history of section 482 provide guidance. The phrase "same interests" includes different persons with a common plan to shift income and deductions. *Brittingham v. Commissioner*, 598 F.2d 1375, 1379 (5th Cir. 1979). Thus, central to the demonstration of "control" by the "same interests" is the establishment of a common design to shift income and deductions. *See Hall v. Commissioner*, 32 T.C. 390, 409-10 (1959).

At the relevant times, [redacted] had as its [redacted]% general partner an individual named [redacted][11] and as its [redacted]% limited partner [redacted] L.P., a Delaware limited partnership. (At the time of the [redacted] transactions, an individual named [redacted][12] was signing legal documents as the general partner of [redacted], although we are unaware of his percentage ownership.) The [redacted]% limited partner of [redacted] L.P. was the [redacted], a tax-exempt entity and well-known accommodation party to tax-shelter transactions, *see, e.g.*, [redacted] The [redacted]% general partner of [redacted] L.P. was [redacted], a Delaware corporation. As of [redacted], the date of the transfer of the [redacted]

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[11] [redacted] has been heavily involved in corporate tax shelters for a number of years. A LEXIS search reveals that at different times he has been either a director or an officer of [redacted] corporations, including [redacted], of which he was president and treasurer.

[12] [redacted] has also been heavily involved in corporate tax shelters for a number of years. A LEXIS search reveals that at different times he has been either a director or an officer of [redacted] corporations, including [redacted].

shares of [redacted] stock to the Taxpayer and as of [redacted], the date of the sale of the [redacted] shares to [redacted], the [redacted]% general partner of [redacted] was [redacted], a Delaware corporation, of which an individual named [redacted][13] was president, and its two [redacted]% limited partners were [redacted] and [redacted]. It appears, therefore, that related parties or interests are on both sides of the respective transactions. Further, it should be pointed out that at the relevant times, an individual named [redacted] was the secretary of the Taxpayer, of [redacted] of [redacted], and of [redacted] and had signed legal documents on behalf of [redacted].[14]

Once control by the same interests is demonstrated by establishing a common design to shift income and deductions, section 482 may be applied to nonrecognition transfers where property was contributed for tax-avoidance purposes. For example, section 482 may allocate income and deductions arising from an entity's disposition of built-in-loss property, which it acquired in a nonrecognition transfer, to the party that contributed it in the transaction. *See* Treas. Reg. § 1.482-1(f)(1)(iii). In this case, the contribution of the [redacted] shares of [redacted] stock is, in substance, a contribution of built-in loss property by [redacted] to the Taxpayer, and the Service should begin by "reallocating back" whatever losses remain to [redacted]

6. Alternatively, whether the adjustment of the claimed loss of $[redacted] is justified as the it was derived from transactions that lacked economic substance?

When a transaction lacks economic substance, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction. A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Rice's Toyota World Inc. v. Commissioner*, 752 F.2d 89, 92 (4th Cir. 1985).

An economic substance analysis hinges on all of the facts and circumstances surrounding the transactions leading up to and involved in a series of transactions in which a taxpayer acquires and sells an asset with a basis traceable to a lease-stripping transaction. No single factor will be determinative. Whether a court will respect the taxpayer's

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13 [redacted].

14 [redacted]

characterization of the transaction depends on whether there is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax-independent considerations, and not shaped primarily by tax avoidance features that have meaningless labels attached. *See ACM Partnership*, 157 F.3d at 247, *aff'g* T.C. Memo. 1997-115; *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990); *Rice's Toyota World, Inc.*, 752 F.2d at 94; *Winn-Dixie v. Commissioner*, 254 F3d 1313, 1316 (11th Cir. 2001), *aff'g* 113 T.C. 254 (1999).

In *ACM Partnership*, the Tax Court found that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. T.C. Memo. 1997-115. The Tax Court further stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transactions lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. *Id.* The opinion demonstrates that the Tax Court will disregard a series of otherwise legitimate transactions, where the Service is able to show that the facts, when viewed as a whole, have no economic substance.

The transactions outlined above, taken as a whole, have no business purpose independent of tax considerations. Because the lease-stripping transactions in which [redacted] acquired the [redacted] shares of stock lacked economic substance, [redacted] had no basis in the stock for the Taxpayer to assume under section 362(a). Moreover, the Taxpayer had no business purpose for acquiring and selling the stock of [redacted] and those transactions lacked economic substance. Consequently, the Taxpayer would have no loss from the transactions.

7. Whether the facts of the case justify assertion of the accuracy-related penalty under section 6662(a)?

Section 6662(a) imposes an accuracy-related penalty in an amount equal to 20% of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, and (3) any substantial valuation misstatement. But no "stacking" of those components of the penalty is permitted. Treas. Reg. § 1.6662-2(c). Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20% (40% in the case of a gross valuation misstatement, I.R.C. § 6662(h)), even if that portion of the underpayment is attributable to more than one type of misconduct (*e.g.*, negligence and substantial valuation misstatement). *See DHL Corp. v. Commissioner*, T.C. Memo. 1998-461 (allowing the Service to alternatively determine that either the 40% gross valuation misstatement penalty under section 6662(h) or the 20% negligence penalty under section 6662(b) applied).

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in preparing a tax return. *See* I.R.C. § 6662(c); Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. *See Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967), *aff'g* 43 T.C. 168 (1964). Negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. Treas. Reg. § 1.6662-3(b)(1)(ii).

In this case, we have a taxpayer that received stock in a purported section 351 transfer on [redacted]. On [redacted], the Taxpayer sold this stock and claimed a loss of $[redacted], which conveniently offset all the capital gains resulting from all its real estate sales occurring in the tax year ended [redacted]. This deal is too good to be true.

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. The term "rules and regulations" includes the provisions of the Internal Revenue Code and revenue rulings or notices issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. Treas. Reg. § 1. 6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of notice or revenue ruling.

Notice 95-53 was issued on [redacted] and therefore before the filing of the return for the tax year ended [redacted] on [redacted]. As a result, the Taxpayer should be held liable for the penalty as it was on notice as to the impropriety of taking advantage of such transactions. And for purposes of this penalty, it should be noted again that [redacted] was the secretary of the Taxpayer at all relevant times and was the secretary of [redacted] at all relevant times. Therefore, it is appropriate to impute his knowledge (or *scienter*) of the underlying transactions from at least the stage of [redacted]'s involvement to the Taxpayer.

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10% of the tax required to be shown on the return or $10,000 in the case of corporations other than S corporations or personal holding companies. I.R.C. § 6662(d)(1). You indicated that the adjustments based on the disallowance of the loss in question meet these technical thresholds.

If a corporate taxpayer has a substantial understatement that is attributable to a tax shelter[15] item, the accuracy-related penalty applies to the understatement unless the reasonable cause exception applies. *See* Treas. Reg. § 1.6664-4(e). The determination of whether a corporation acted with reasonable cause and good faith is based on all pertinent

[15] The definition of tax shelter includes, among other things, any plan or arrangement a significant purpose of which is the avoidance or evasion of income tax. I.R.C. § 6662(d)(2)(C)(iii).

facts and circumstances. Treas. Reg. § 1.6664-4(e)(1). A corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if there is substantial authority within the meaning of Treas. Reg. § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that such treatment was more likely than not the proper treatment.[16] Treas. Reg. § 1.6664-4(e)(2)(i). Based on all the above-described facts, we find the existence of neither substantial authority nor reasonable belief in the "more likely than not" standard.

In the unlikely event that the Taxpayer meets the "substantial authority" and "belief" requirements, that is still not dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose or if the taxpayer claimed benefits that were unreasonable in comparison to the initial investment in the tax shelter. Treas. Reg. § 1.6664-4(e)(3). As noted above, the Taxpayer's participation does lack business purpose and it is a deal too good to be true.

For the accuracy-related penalty attributable to a substantial valuation misstatement to apply, the portion of the underpayment attributable to a substantial valuation misstatement must exceed $10,000 in the case of a corporation other than an S corporation or a personal holding company. A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200% or more of the amount determined to be the correct amount of such value or adjusted basis. I.R.C. § 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400% or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement." I.R.C. § 6662(h)(2)(A). If there is a gross valuation misstatement, the 20% penalty under section 6662(a) is increased to 40%. I.R.C. § 6662(h)(1). One of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. *Gilman v. Commissioner*, 933 F.2d 143, 150-52 (2d Cir. 1991), *cert. denied*, 502 U.S. 1031 (1992). If the facts establish that the adjusted basis of an asset with a basis traceable to a

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[16] The regulations provide that in meeting the requirement of reasonably believing that the treatment of the tax shelter item was more likely than not the proper treatment, the corporation may reasonably rely in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in Treasury Regulation section 1.6662-4(d)(3)(ii) *and* the opinion unambiguously states that the tax advisor concludes that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged by the Service. Treas. Reg. § 1.6664-4(e)(2)(i)(B)(2). As noted in the facts section, the Service has requested all documents related to the transaction, including legal opinions, but the Taxpayer has refused to cooperate. As a result, it is appropriate to apply the general rule that a taxpayer who fails to produce evidence within his possession has evidence which is not favorable to him. *Recklitis v. Commissioner*, 91 T.C. 874, 890 (1988); *Wichita Terminal Elevator Co. v. Commissioner*, 6 T.C. 1158, 1165 (1946), *aff'd*, 162 F.2d 513 (10th Cir. 1947).

lease-stripping transaction is 200% or more of the correct amount, then either a substantial valuation misstatement or a gross valuation misstatement may exist.

In this case, it appears quite appropriate to assert the accuracy-related penalty on the ground that a valuation misstatement exists in view of the lack of economic substance with regard to the underlying transactions and those involving the Taxpayer and the exaggerated amount of loss claimed on the return for the tax year ended [redacted].

In summary as to the accuracy-related penalty, it should be asserted as to the adjusted loss on the three alternative grounds of lack of economic substance, failure to meet the business-purpose test, and reallocation under section 482.

If you have any questions, please call me at (619) 557-6014. We are submitting this memorandum to our National Office under the 10-day post-review procedures. We will advise you once we have received National Office concurrence in our conclusions.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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